STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	)	
	)	Docket No. 04-0442
Proposed general increase in water rates.	)	

REPLY BRIEF OF
AQUA ILLINOIS, INC.

Dated: December 17, 2004

Attorneys for Aqua Illinois, Inc.:

John E. Rooney
Sarah A. Naumer
Sonnenschein, Nath & Rosenthal
233 S. Wacker Drive
Chicago, Illinois 60606
312-876-8000
jrooney@sonnenschein.com
snaumer@sonnenschein.com

TABLE OF CONTENTS

Page

I. Introduction....1
II. Argument....2
A. Rate Base....2
B. Operating Expenses....3
1. Payroll Expense: Staff's Adjustment Is Erroneous In Numerous Respects....3
a. The Evidence Establishes Aqua's Budgeting Process Is Sound....4
b. Staff's Claim T Is Proposing A Payroll Increase Is Not Correct....5
c. Staff's Claim That Plant *Increases* Cause Payroll *Decreases* Is Not Accurate Or Supported By The Evidence....6
d. An Adjustment To Contractual Services Should Be Made If The Commission, For Some Reason, Makes One To Payroll Expense....7
2. Incentive Compensation: Staff's Adjustment Is Flawed Entirely....9
3. Collections Expense: Staff's Double Adjustment Is Inappropriate....14
4. Advertising Expense: Staff's Adjustment Would Disallow Expenses For Important, Customer Informative Advertisements....15
5. Charitable Contributions: Staff's Adjustment Would Disallow Expenses That Satisfy The Statutory Standard For Recovery....18
6. Rate Case Expense: Aqua Has Fully Supported This Known And Measurable Change....20
C. Rate Of Return....22
1. Capital Structure, Cost Of Preferred Stock, And Cost Of Debt....22
2. Cost Of Common Equity....23
a. Aqua's Requested Rate Of 10.75% Should Be Adopted....23
i. Size-Based Risk Premium....23
ii. NAIC-2 Designation....24
iii. Reliance On Historical Data....24
iv. DCF Analysis....25
v. CAPM Analysis....25
vi. Empirical CAPM....26
vii. Risk Premium Analysis....27
viii. CEM Analysis....27
b. Staff's Analysis Should Not Be Adopted But, If For Some Reason It Is, The Major Flaws Must Be Corrected....28
i. Aqua's NAIC-2 Rating....29
ii. Increased Interest Rates....31
D. Rate Design....32
1. Customer Charge....32
2. Large Industrial Customer Class Rate - Teepak....33
III. Conclusion....36

I.
Introduction

Examination of the Initial Briefs demonstrates that Aqua Illinois (“Aqua”) and the Commission Staff (“Staff”) are in agreement on the vast majority of issues related to Aqua’s request for a rate increase for its Vermillion Division. It is Aqua’s position that agreement on so many issues reflects the fact that its proposed increase is based on a careful, reasonable presentation of the cost increases that the Vermillion Division will experience during the 2005 Test Year. The evidence further establishes that its’ proposed rates for the Test Year results in a modest increase of only 3.54% annually since the Vermillion Division’s last rate case in 2000. Such a modest increase demonstrates that Aqua’s management has worked hard to keep costs in line, while providing quality service to its customers. For example, in this proceeding Aqua is seeking recovery of Payroll Expense that is approximately $70,000 less than what the Commission approved in the 2000 rate proceeding.

Aqua and Staff disagree on three categories of issues: 1) certain proposed adjustments to operating expenses; 2) the appropriate Return on Equity (“ROE”) for the Vermillion Division; and 3) certain Staff adjustments to Aqua’s proposed rate design. None of Staff’s proposed adjustments are reasonable.

The evidentiary record demonstrates that Staff’s proposed adjustments to certain operating expenses either are in conflict with a recent Commission Order involving Aqua’s Kankakee Division (ICC Docket No. 03-0403 (issued Apr. 13, 2004)), are contrary to the Public Utility Act (“Act”), 220 ILCS 5/1-101 et seq., or are unsupported by the evidentiary record. Aqua, meanwhile, has presented compelling evidence and authority which demonstrates that its proposed operating expenses are reasonable and should be accepted.

Similarly, Staff's proposed ROE is in conflict with the Commission's April 2004 Kankakee rate Order. In that Order, the Commission determined that 30 basis points should be added to Staff's proposed mid-point to reflect the risk inherent in operations similar to Aqua. The Commission's decision resulted in a 10.16% ROE. Here, the evidence demonstrates that such risk actually has increased since that Order. However, Staff suggests a ROE of only 10.07%. At a minimum, applying the Commission's recent reasoning in the Kankakee Order, an ROE of 10.37% is warranted.

With respect to rate design, Staff's proposed customer charge and Large Industrial Customer Class rate are unreasonable and should not be accepted. The proposed customer charge fails to collect for costs that are appropriately recovered in the customer charge. As for the Large Industrial Customer Class rate, Staff seeks to impose a 35% increase to a rate that only has one customer—Teepak. The Mayor of Danville and local civic organizations have urged a far smaller increase for fear that Teepak will leave the Aqua system, and possibly move its operations from the State. In short, Staff's proposal would have the Commission as well as the Company and consumers in the area take the risk that of one of the largest employers in the area will not leave Aqua's system or the State. Aqua does not believe the Commission should be placed in the position to take such a risk.

In sum, Aqua's proposed increase in rates for its Vermillion Division, and resulting rate design, is reasonable and supported by compelling evidence. Accordingly, Aqua urges the Commission to reject Staff's proposed adjustments.

II.
<u>Argument</u>

A. Rate Base

As noted in Aqua's Initial Brief, there are no rate base related issues outstanding.

B. Operating Expenses

1. Payroll Expense: Staff's Adjustment Is Erroneous In Numerous Respects

Aqua explained in its Initial Brief that its budgeted $1,087,387 in Payroll Expense for 2005 is fully supported. It is based on a budget that has been deemed compliant with applicable accounting standards by the independent accounting firm London Witte Group, Inc. ("London Witte"). It is, moreover, $68,534 less than the Commission allowed for Vermilion in Docket No. 00-0339 even though significant factors driving payroll increases are present. As explained herein, Staff's Initial Brief does nothing to rebut the veracity of these facts.

Rather, Staff's Initial Brief confirms the erroneousness of its Payroll Expense adjustment. It is beyond question that the adjustment is historically focused, despite the fact that a future test year is at issue. (*See*, Staff IB, pp. 9-10). Staff provides no basis for engaging in such a backward-looking design for a future budget year. As Aqua explained in its Initial Brief, doing so will produce a budget that does not contain relevant or useful information for the future test year. (Aqua IB, pp. 4-6). It likely will be unreliable and produce budget variances during the coming years. (*Id.*, pp. 4-8).

It is, therefore, important that the Commission not adopt Staff's proposed adjustment. Aqua witness Mr. Schreyer explained that doing so would send all utilities the improper policy signal that utilities should hastily hire to ensure that below-budget payroll variances do not occur for which they will be penalized in future rate cases. (Aqua Ex. S-2.0, p. 10). The penalty that utilities would perceive would be real, as the evidence demonstrates that Staff's adjustment will impact jobs either by removing the funds to fill vacant positions or by reducing employee wages in real dollars. (*Id.*, pp. 16-17). Utilities should not be required to face such personnel hurdles while undertaking to provide quality service to consumers. The Commission should absolutely reject Staff's adjustment.

a. The Evidence Establishes Aqua's Budgeting Process Is Sound

Staff argues its adjustment should be adopted because the budgeting process Aqua used historically has not changed. (Staff IB, p. 10). Staff, however, did not introduce evidence of (and in fact did not even identify) any aspect of the budgeting process that is allegedly incorrect. There is no evidence that anything is wrong with Aqua's budgeting process.

To the contrary, the uncontested evidence establishes that Aqua's budgeting process is in accord with the American Institute of Certified Public Accountants' Guidelines. (Aqua Ex. R-2.0, p. 2). The independent accounting firm London Witte Group, Inc. ("London Witte") closely scrutinized Aqua's budget and determined it was established pursuant to the applicable accounting standards. (*Id.*) London Witte further determined that Aqua's projections for 2005 are reasonable and based on realistic assumptions. (*Id.*) Aqua witness Jack Schreyer attested to the fact that Aqua used the most recent information available and needs known for 2005. (*Id.*) As London Witte determined, this process is exactly how a future budget should be developed. (*Id.*) Staff's adjustment is attempts to fix a process that simply is not broken.

What Staff disregards in trying to "fix the process" is the substantial evidence that Aqua's historical payroll variances did not occur because of any problem with the budgeting process. The *actual* causes were position vacancies and significant but unanticipated capital projects, neither of which is projected to exist or, therefore, to cause budget variances in 2005. (*See*, Aqua IB, pp. 4-6). Staff, however, chose not to conduct any investigation into these matters. (*Id.*; Tr., p. 247). In short, Staff has failed to consider the true influencing factors or assess what role those factors are projected to play in 2005.

A budget is a future projection and, while it is never intended to (nor could it realistically) be 100% accurate, it must be designed to project the future year to which the budget will apply. If the budget is not designed to do so, for example by being designed to account for historical factors that are not projected to exist in the budget year, then it simply will not be based on relevant information and will not be realistic. Staff's adjustment, which would cause such an erroneous and unrealistic end result, should not be adopted.

b. Staff's Claim That It Is Proposing A Payroll Increase Is Not Correct

Staff next asserts that its adjustment would constitute a Payroll increase. (Staff IB, pp. 10-11). In particular, Staff notes that its proposed Payroll is $65,858 higher than Aqua's 2001 actual Payroll. (*Id.*) Staff's reliance on 2001 actual Payroll, however, is a fatal error.

The evidence shows that the factors causing Aqua's historical[1] Payroll variances, (*i.e.*, position vacancies and unanticipated capital projects), existed in 2001 and caused a Payroll variance in that year. (*See*, Aqua IB, pp. 4-5). As such, actual 2001 Payroll is not a reliable basis for Staff's analysis. Because the historical factors interceded in 2001, actual 2001 Payroll is not representative of any year in which those interceding factors are not projected to intercede or exist. The evidence is undisputed that those factors are not expected to interfere in 2005. (*Id.*, pp. 4-6). Staff's analysis, therefore, does not demonstrate that it is proposing a Payroll increase for any year, like 2005, in which temporary position vacancies or unanticipated capital projects are not projected to occur.

The evidence does establish, however, that Staff is proposing a Payroll *decrease*. (*Id.*, p. 3). Unlike actual 2001 Payroll that Staff relies upon, Aqua's Payroll budget as approved by the Commission in Docket No. 00-0339 was not influenced by the factors that caused the variance. In other words, the budget was designed assuming no position vacancies and no unanticipated capital projects. It is, therefore, representative of the amount of Payroll the Commission deemed appropriate for Aqua in years in which those factors do not exist. This is

[1] The term "historical" in this context only means 2001 to June 2004, which is the historical period Staff relies upon for its adjustment. It should not be interpreted to indicate that Aqua had Payroll variances in other historical years when the factors that caused the variances in 2001 to June 2004 did not exist.

the amount that is appropriate for comparison to determine whether the budget for 2005, when those factors are not projected to exist, is increased or decreased. This correct apple-to-apple comparison shows that Staff actually is proposing a Payroll decrease of $158,663. (Aqua Ex. S-2.0, pp. 11, 16-17).

c. Staff's Claim That Plant *Increases* Cause Payroll *Decreases* Is Not Accurate Or Supported By The Evidence

The evidence establishes that two factors have been driving payroll increases since the Commission-approved budget in Docket No. 00-0339.[2] The first factor is the annual cost of living increase. (Aqua Ex. S-2.0, p. 16). Staff does not dispute that annual cost of living increases are wage drivers or that Aqua's employees should receive these increases. Aqua witness Schreyer testified that one undesirable result of Staff's Payroll adjustment could be the elimination of these increases and, in fact, even the reduction of employee wages in real dollars. (*Id.*, p. 17).

The second factor driving Payroll increases is the significant increase in utility plant-in-service. In total, the evidence establishes a 31.8% increase in addition to Aqua's acquisition of the Indianola system. (*See*, Aqua IB, p. 3). Aqua witness Mr. Schreyer testified that this more than 31.8% increase is a significant factor driving Payroll increases because more personnel are required to manage the substantially greater amount of plant-in-service. (Aqua Ex. S-2.0, p. 16). Staff did not rebut this evidence whatsoever through its own witnesses.

Staff did attempt, however, to question Aqua's evidence on this latter point at hearing, but was unsuccessful in doing so. Staff counsel asked several times for Mr. Schreyer's agreement that new plant requires less maintenance and, thus, less Payroll, but Mr. Schreyer did

[2] As explained in its Initial Brief, Aqua believes is maintenance of Payroll costs (and in fact a requested decrease of $68,534) despite these factors driving increases demonstrates Aqua's effective management of its labor costs. (Aqua IB, p. 3).

not agree. (Tr., pp. 128-29). He answered with: "*I couldn't say that* unless I saw the plant we are talking about" and "*I wouldn't want to make a blanket statement like that* unless I saw the numbers that I was talking about and the plant." (Tr., p. 129 (*emphasis* added)). In other words, Staff's blanket assertion does not hold. There is no evidence to the contrary (*i.e.*, no evidence that it does hold).

Staff, nonetheless, sets forth in its Initial Brief argument to rebut Aqua's position that is wholly reliant on this blanket assertion with which Staff could not get Mr. Schreyer to agree. (Staff IB, p. 11). Staff argues that that Aqua's *more than 31.8% increase* in plant actually drives Payroll *decreases*. There is absolutely no evidentiary foundation for Staff's argument. Staff's own witnesses did not testify as to such factual allegations, and Mr. Schreyer did not agree. The Commission should not give any consideration to Staff's attempt to weaken Aqua's evidence in this regard.

d. An Adjustment To Contractual Services Should Be Made If The Commission, For Some Reason, Makes One To Payroll Expense

For all the reasons set forth herein and in Aqua's Initial Brief, the Commission should not adopt Staff's Payroll adjustment. Nonetheless, should the Commission for some reason do so, it is important that the adjustment not be one-sided. In particular, the evidence establishes that Aqua accounted for position vacancies, in part, through a greater reliance on outside contractual services, and that Outside Contractual Services – Other likewise experienced budget variances, but in the opposite direction, as a result. (*See*, Aqua IB, pp. 9-10). As such, if an adjustment is made to Payroll because of its historical variances then an adjustment also should be made to Contractual Services for the same reason.

Staff's Initial Brief confirms that its basis for not recommending the Commission do so, (*i.e.*, for recommending a one-sided Payroll adjustment) is flawed entirely. In particular, Staff initially asserts that evidence of historical budget variances for Contractual Services does not exist. Staff states:

> Staff does not have information indicating a similar history of under (or over) budgeting Contractual Services – Other. Had Staff observed a similar sustained pattern of budget variances in Contractual Services – Other, a similar adjustment might have been proposed.

(Staff IB, p. 12). Such statements are surprising as the evidence is unambiguous that Contractual Services did, in fact, sustain a virtually identical pattern of budget variances as Payroll, albeit, as noted, in the opposite direction. The facts are that Contractual Services – Other was under-budgeted for the years 2001 – 2003 by $327,778 or 45%. (Aqua Ex. R-2.0, pp. 13-14 *citing* Aqua Sch. G-9, pp, 2, 4, 6, col. (E), ln. 9). Staff witness Ms. Ebrey even agreed on examination that Contractual Services experienced these historical variances, and that the average annual variance was $109,259 (similar to the $90,129 Staff observed for Payroll). (Tr., pp. 149-50). Staff's claim that Contractual Services has not experienced a historical budget variance totally disregards this clear evidence.

Staff next asserts for the first time in its Initial Brief that "[w]hat Staff did observe is that there have been elements unrelated to payroll costs that *have impacted* the level of Contractual Services required, most notably sludge hauling expense." (Staff IB, p. 13 (*emphasis* added)(past-tense reflecting Staff's incorrect belief of a past impact)). The evidence establishes, however, that sludge hauling expense is completely unrelated to the expenses Aqua historically has included in its account for Contractual Services. During all historical periods, Aqua accounted for sludge hauling in a balance sheet reserve account, completely separate from Contractual Services. (Aqua Ex. S-2.0, pp. 13-14; Aqua Cross Ex. 2, p. 2). Sludge hauling simply could not have impacted Contractual Services historically.

Staff does not identify even a single other factor that it alleges caused the historical variances in Contractual Services. As there is no evidence of such other factors (and, indeed, there is no evidence that sludge hauling caused the historical variances either) there is no basis for Staff's claim that historical variances were caused by any factors other than those to which Aqua testified. The only evidence, as Aqua testified, is that the Contractual Services variances were caused in large part by the same factors that caused the Payroll variances. The evidence supports a consistent adjustment to Contractual Services should one be made to Payroll.

2. Incentive Compensation: Staff's Adjustment Is Flawed Entirely

As Aqua set forth in its Initial Brief, the Commission already has ruled that expenses incurred under Aqua's plan are recoverable.[3] (Order, Dkt. 03-0403, p. 15). While Staff is correct that the Commission's rulings are not *res judicata*, (Staff IB, p., 22), the law is clear that the Commission cannot act in an arbitrary and capricious manner. *Commonwealth Edison Co. v. Illinois Commerce Comm'n.*, 180 Ill. App. 3d 899, 907, 536 N.E.2d 724, 729 (1st Dist. 1988) *as modified Feb. 14, 1989*. It must have a rationale basis for reversing an earlier decision.[4] *Id.*

This standard is not one that is appropriately characterized as relaxed or deferential, as Staff appears to assert. In particular, Staff argues the Commission can come to a different decision as to recoverability of expenses incurred under Aqua's plan simply because Staff raises arguments in this case that Staff, allegedly, did not advance in Docket No. 03-0403. (Staff IB, p. 20). However, the courts have held that on review of arbitrary and capricious action agencies are not shielded "from a thorough, probing, in-depth review" and that any review is to be "searching and careful." *People v. United States*, 666 F.2d 1066, 1073 (7th Cir. 1981)(case addressing a Commission decision). An important consideration in such a review is whether the

[3] Staff objects to Aqua's recovery of its increased rate case expense, as discussed *infra*, while forcing Aqua to re-litigate this issue that the Commission just resolved in April of this year.
[4] Indeed, even Staff concedes, as it must, that the Commission cannot "totally ignore its actions in prior dockets." (Staff IB, p. 22).

decision in question differs from other findings as to the same facts. *Id.* at 1073-74. It is also stated that uniformity of interpretation is an important factor that is considered. *Ebert v. Connecticut Gen. Life Ins.*, 900 F.2d 1032, 1037 (7th Cir. 1990). The Illinois Supreme Court has expressly held that the Commission's decisions "are entitled to less deference when [the Commission] drastically departs from past practice." *Business and Prof. People for the Public Int. v. Illinois Commerce Comm'n.*, 136 Ill. 2d 192, 228, 555 N.E.2d 693, 709 (1989) *as modified on denial of reh'g.*

Indeed, in *Commonwealth Edison*, the Commission had issued an order on April 27, 1988 as to rates in a tariff filing. The court explained that the Commission's order "was entered after more than two years of litigation … including several hearings, extensive briefing … and detailed findings of fact" and that the order "represented a careful resolution of the controversy." 180 Ill. App. 3d at 907, 536 N.E.2d at 729. Then, on June 8, 1988, less than two months later, the Commission entered an order that established different rates. *Id.* The court stated that in its opinion "the Commission's decision to supersede rates it had determined to be in the public interest less than two months earlier was arbitrary and capricious." *Id.*

Aqua's actual plan pursuant to which expenses are incurred is in evidence as is the materially *identical* plan the Commission considered in Docket No. 03-0403. (Aqua Cross Ex. 4). Staff has admitted that there is no material difference between the two plans. (Tr., pp. 258-59; Aqua Cross Ex. 3). No rationale basis exists for ruling differently on recovery under the exact same plan in two different proceedings taking place within the very same year.

Staff attempts to bypass this significant barrier to its adjustment by claiming that it has raised new issues with respect to Aqua's plan that the Commission did not consider previously. (Staff IB, p. 20). However, as noted above, new arguments do not alter the factual aspects of the plan. The Commission, after extensive litigation in Docket No. 03-0403, found that Aqua's recovery of expenses is appropriate based on the facts of the materially identical plan at issue in that case.

Irrespectively, it should be noted that the Commission itself stated that it considered the plan "[a]s a whole" in Docket No. 03-0403. (Order, Dkt. 03-0403, p. 15). Indeed, the Commission's Order even expressly rules on Staff's two primary arguments in this proceeding. Staff's two primary arguments relate to the fact that payments are tied, in part, to Aqua's financial goals.[5] (*See*, Staff IB, pp. 14-16). The Commission's Order states:

> As a whole, the program appears to set targets for a broad range of objectives, *rather than tying compensation directly to earnings performance*. Many of the goals established by the Company promote ever-increasing water quality, customer service, and system safety. *While investors may derive some benefit from certain cost reduction goals*, the Commission is of the opinion that ratepayers are the primary beneficiaries of the incentive compensation program as a whole.

(Order, Dkt. 03-0403, p. 15)(*emphasis* added). Clearly, the Commission has considered already the relationship to Aqua's financial goals in determining that Aqua's expenses under the plan are recoverable. Staff has raised nothing new in its first two arguments.

Similarly, the Commission already considered the changes to the plan during the 2001 to 2003 period that Staff advances now in support of the allegedly "new" issues Staff is raising. (*See*, Staff IB, pp. 17-19 (advancing these earlier changes in support of its arguments)). Changes to the plan between 2001 and 2003 were already adopted and incorporated into the plan before the Commission in Docket No. 03-0403. The results of those changes were inherently integral

[5] Staff's primary argument is that payment is tied to financial goals, and its second argument is that payments may not be made because goals, including financial goals, may not be met. (*See*, Staff Ex. 6.0 p. 10).

parts of the plan the Commission ruled upon in that case. Such changes simply cannot be a basis to distinguish the plan at issue in this case from the one considered in Docket No. 03-0403.

Accordingly, Staff has not identified any basis for the Commission to rule differently in this case than it did in Docket No. 03-0403. Nor has Staff provided any reason for the Commission to tie itself to its rulings in cases involving other utilities' incentive compensation plans. (Staff IB, pp. 15-20 (repeatedly arguing that the Commission should rely on rulings on plans by Illinois Power, CILCO, MidAmerican Energy, Ameren and Citizens Utilities)). While the evidence establishes indisputably that Aqua's plan is the same one considered in Docket No. 03-0403, (Aqua Cross Ex. 4), Staff has introduced no evidence as to the nature of the plans of the other utilities upon which the Commission ruled in the other cases that Staff cites. No basis exists to conclude that Aqua's plan is similar to those of the other utilities, as Staff asserts, but somehow different than the identical plan in Docket No. 03-0403. Staff's effort to have the Commission rely on Orders in cases other than Docket No. 03-0403 is a non-starter.

Ultimately, Staff relies heavily on these erroneous arguments in its Initial Brief with respect to each of the five reasons it advances for ruling inconsistently with Docket No. 03-0403. To the extent Staff raises any other argument with respect to any of its asserted reasons, the argument is addressed in turn:

Staff Reason #1: The plan is dependent upon financial goals which benefit shareholders and not ratepayers.

- Staff criticizes Aqua for focusing on ratepayer benefits (Staff IB, p. 15); but, as discussed *supra*, the Commission already ruled in Docket No. 03-0403 that ratepayer benefits outweigh any benefit to shareholders under this very same plan.

Staff Reason #2: The goals in the plan may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding.

- Staff acknowledges that Aqua met its budget in 2001, but asserts Aqua was under-budget in 2002 and 2003. (Staff IB, p. 16 *citing* Aqua Response to TEE 2.01). Staff fails to inform the Commission that Aqua has adjusted its budget already, on its own initiative, to reflect the reduced payments in 2002 and 2003. The average amount paid during 2001 to 2003 was $36,826 ($110,478 / 3 = $26,826). (Aqua Ex. S-2.0, p. 20). Aqua's budget for 2005 is $3,036 less than this historical average. (*Id.*)

- Staff claims there is no evidence of goals being met; but, Aqua has made payments since 1995 because goals have been met consistently. (Aqua Ex. S-2.0, p. 20). Aqua paid $110,478 between 2001 and 2003. (*Id.*) Aqua also provided examples of numerous instances in the past two years in which payments have been made for specific employee achievements. (*Id.*, Sch. S-2.2). Staff's assertion that employees would suddenly cease meeting goals is pure speculation.

Staff Reason #3: The plan is discretionary and may be discontinued at any time.

- Staff raises no arguments here other than the ones discussed generally *supra*. However, Staff does note the plan's discontinuance for union employees in June, 2004. As such, it bears emphasis the plan already was discontinued for union employees when the Commission considered the plan's recovery in Docket No. 03-0403.

Staff Reason #4: There is not sufficient comparable historical data on which to determine if the test year level is reflective of a normal level.

- Again, Staff raises no arguments here other than the ones discussed generally *supra*. However, because Staff again notes the plans previously different employee coverage, it again bears emphasis that the changes to the plan's employee coverage already had occurred when the Commission considered the plan's recovery in Docket No. 03-0403. As such, virtually the same historical data underlay the Commission's ruling in Docket No. 03-0403.

Staff Reason #5: The disallowance of incentive compensation is consistent with prior Commission Orders.

- Staff raised no new arguments here, but rather reiterates its surprising position that a Commission ruling *inconsistent* with its Order in Docket No. 03-0403 would somehow be *consistent* with its prior rulings.

As is clear, none of Staff's advanced reasons would justify the Commission ruling differently on recovery under this plan than it did in Docket No. 03-0403. Rather, the evidence establishes that Aqua's plan provides substantial consumer benefits by giving employees appropriate incentives. (*See*, Aqua IB, pp. 14-16). The Commission should approve Aqua's recovery of expenses incurred under the plan.

3. Collections Expense: Staff's Double Adjustment Is Inappropriate

Staff proposes a $19,246 adjustment to the Vermillion Division's Management Fees which is legally and factually flawed. In short, Staff seeks to have Aqua prove a negative. Staff's Brief provides:

> Since the burden of proof in a rate case lies with the Company … *and the Company failed to support its claim that the costs associated with the Remittance Center are not included in the increase in Management Fess for the test year*, Staff's adjustment is reasonable and should be approved.

(Staff IB, p. 32)(*emphasis* added). Staff's position is wholly improper and should not be accepted.

Initially, Staff has misapplied the appropriate legal standard. Aqua agrees that it has the burden of proof in this proceeding, and it has met its burden. Staff, however, has the burden of going forward in supporting its proposed adjustment. *City of Chicago v. Cook County*, 133 Ill. App. 3d 435, 442-43, 478 N.E.2d 1369, 1375 (1st Dist. 1985). In this regard, Staff has failed to meet its legal burden on this issue as it offered no facts, just a solitary presumption.

The evidence demonstrates that Aqua agreed to remove $19,246 from its Collection Expense in response to Staff's Direct Testimony. (Aqua Ex. R-2.0, pp. 25-26). Staff agrees that this adjustment was made. (Staff Ex. 6.0, p. 24, Tr., pp. 230-31). Yet, in her rebuttal testimony, Staff witness Ebrey proposes to remove *the exact same amount*, this time from the Management Fees. (Tr., p. 232). Staff offers no facts to support this adjustment. Instead, the sole basis for Staff's proposal stems from Ms. Ebrey's "presumption" that such an amount somehow exists in Aqua's Management Fees account. (Tr., p. 234). Aqua respectfully submits that such a presumption is not evidence that should be relied upon. Moreover, the presumption is wrong.

In contrast, Aqua agreed to remove the figure where it actually existed—in Collection Expense. (Aqua Ex. R-2.0, pp. 25-26). Moreover, Aqua responded to a Staff data request that no such sum existed in the Management Fees account. (Aqua Cross Ex. 1). Aqua, however, cannot prove a negative—that is, something that does not exist. The facts demonstrate that only one adjustment is appropriate, and that Aqua agreed to such an adjustment in its rebuttal testimony. There is no evidence that this phantom amount somehow exists in the account in question. Accordingly, Staff's proposed adjustment to Management Fees should be rejected.

4. Advertising Expense: Staff's Adjustment Would Disallow Expenses For Important, Customer Informative Advertisements

Aqua has fully supported its advertising expense. (See Aqua IB, pp. 18-23). The portion of the expense Staff seeks to disallow is for advertisements that provide important information to customers regarding water quality, water service and rates. (*Id.*) It is within the best interest of consumers to receive this type of information.[6] Indeed, several of the advertisements fall within categories the General Assembly expressly has provided "shall" be recovered. (*Id.*, pp. 21-22 *citing* 220 ILCS 5/9-225(3)).

Staff's Initial Brief does not rectify the infirmities underlying its proposal to disallow $9,246 of this expense. Rather, it is clear Staff's adjustment is based solely on its witness Ms. Ebrey's subjective opinion that likely is not representative of consumers' opinions. (*Id.*, pp. 19-23). It is difficult to believe, as Ms. Ebrey opines, that consumers do not want to receive information related to water quality, service quality or rates. (*Id.*) Moreover, a group of Aqua's customers, whose purpose is to advance the interest of the community, has an opposite opinion from that of Ms. Ebrey. (*Id.*, pp. 22-23).

[6] Aqua does not agree that Section 9-225 of the Public Utilities Act ("PUA") applies to water utilities; but, if the Commission uses Section 9-225 as a guideline, the standard it sets forth is that utilities should recover expenses for advertisements that are "in the best interest of the Consumer." 220 ILCS 5/9-225(2). The evidence demonstrates that Aqua's advertisements Staff questions are, in fact, in the best interest of the consumers because they provide valuable information that is beneficial to consumers to receive.

Importantly, it now appears that Ms. Ebrey may have developed some of her opinions as to recoverability of Aqua's expense by applying an inappropriate standard. Staff clarifies in its Initial Brief that it has "never disputed the informative value of the advertisements."[7] (*Id.*, p. 24). Section 9-225 of the Act states that advertising that is in the best interest of consumers is recoverable. 220 ILCS 5/9-225. Advertisements that provide consumers valuable information, which Staff agrees Aqua's do, should satisfy this standard.

Staff asserts, nonetheless, that while the advertisements provide consumers valuable information, the expenses are not recoverable because the advertisements also, allegedly, provide some benefits to Aqua. (*Id.*) This assertion disregards the guideline for recovery Section 9-225 sets forth:

> In any general rate increase requested by any gas or electric utility company[8] under the provisions of this Act, the Commission shall not consider … expenditures for promotional, political, institutional or goodwill advertising, *unless the Commission finds the advertising to be in the best interest of the Consumer* or authorized as provided pursuant to subsection 3 of this Section.

220 ILCS 5/9-225(2)(*emphasis* and footnote added). This plain language unambiguously provides that advertisements in the best interest of consumers are recoverable even if there is an ancillary promotional benefit. This is important because many advertisements that provide consumers valuable information also may instill in some consumers a positive attitude toward the utility. As one example, consumers may have a positive image of Aqua from knowing that Aqua is in compliance with the IEPA's Safe Drinking Water standards, but it is nonetheless in consumers' best interest to be informed of whether or not Aqua is in compliance. Section 9-225

[7] Indeed, Staff even goes so far as to criticize Aqua for characterizing Staff's position as being based on an opinion that the advertisements in question are not informative to consumers. (Staff IB, p. 24).
[8] This Section by its express terms only applies to gas and electric utilities.

provides that Aqua's expenses for brining this type of valuable information to consumers are recoverable even if some consumers think positively toward Aqua as a result.

Irrespective, the evidence establishes that the purpose of Aqua's advertisements is not to promote its image but rather to inform consumers of valuable information. Aqua simply has no reason to engage in self-promotional activities. Aqua is the only water utility certificated to provide service in Vermilion, so there is absolutely no need for Aqua to do so. (Aqua Ex. R-2.0, p. 27). Review of the transcripts clearly reveals that the advertisements are not designed to promote Aqua but rather are designed to provide consumers with beneficial information. (*See*, Aqua IB, pp. 18-23).

Staff's claim that Aqua has not support an approximate $3,000 increase[9] in commercial newspaper advertising expense generally suffers from this same problem and also is contradicted by the evidence. Aqua witness Mr. Schreyer testified that the increase is also necessary to provide consumers with valuable information about planned projects that will impact both water and service quality. (Aqua Ex. S-2.0, pp. 24-25). The evidence further establishes that a Community Advisory Panel, (*i.e.*, a group of Aqua's customers whose purpose is to advance the community's interest), has deemed Aqua's previous level of advertisements of this nature inadequate, and have expressed their opinion that the level should be increased. (*Id.*) Local consumer groups are in a good position to know whether (a) consumers actually deem this type of advertising beneficial, and (b) an increase in the level of this type of advertising is needed. This evidence clearly demonstrates a need to increase the level of advertising to provide consumers with valuable information related to future projects that will impact water and service quality.

[9] Staff's proposal to disallow this $3,000 increase is part of Staff's total adjustment of $9,246.

Finally, it should be noted that Staff is mistaken about two aspects of this latter evidence. First, Staff states that the projects about which these advertisements will inform consumers are *current* projects and asserts Aqua has not explained how current projects will increase the need for advertising in 2005. (Staff IB, p. 27). However, Aqua has identified a significant number of projects planned for 2005 that will impact both water and service quality, and about which customers should be informed. (Aqua Ex. 1.0, pp. 13-14; Ex. 1.1). These projects were included in rate base. (Aqua Ex. B-5, p. 1). Staff, by virtue of agreeing to Rate Base, acknowledges these projects will take place. Thus, the evidence does establish planned projects for 2005 that support Aqua's advertising budget for that year. Second, Staff implies that the Community Advisory Panel is an internal arm of the Company implicitly representing Aqua's own opinion. (Staff IB, p. 27). Staff's position, however is based on speculation, not fact. Staff never sought out the Community Advisory Panel to assess its role and its relationship with Aqua. The Community Advisory Panel is a group of Aqua's customers with the purpose of advancing the interest of the Vermilion community. (*See*, Aqua IB, p. 23). It has not, therefore, advanced Aqua's position but rather has advanced its own in an effort to promote the community's interest.

Accordingly, Aqua has demonstrated both that its advertisements are designed to benefit consumers by providing important information and that this expense should be increased to allow for a sufficient level of advertising of upcoming projects that will impact both water and service quality. The Commission should not adopt any aspect of Staff's adjustment.

5. Charitable Contributions: Staff's Adjustment Would Disallow Expenses That Satisfy The Statutory Standard For Recovery

Aqua has demonstrated that all of its charitable contributions satisfy the statutory standard for recovery. (Aqua IB, pp. 23-28). In contrast, Staff's Initial Brief reveals that Staff has misapplied the applicable statutory standard. The statute provides:

> It shall be proper for the Commission to consider as an operating expense … donations made by a public utility *for the public welfare* or *for charitable scientific, religious or educational purposes*, provided that such donations are reasonable in amount.

220 ILCS 5/9-227 (emphasis added). Based on this plain language, the purpose of the contribution is controlling. Staff, however, repeatedly places form over substance by looking at how the donations are made, (*i.e.*, procedure), rather than looking at what purposes the donations serve, (*i.e.*, substance). Indeed, Staff even admitted it did not talk with recipients to determine how Aqua's donations have actually been used. (Tr., pp. 268-70). Each of the three categories of contributions Staff seeks to disallow is addressed in turn.

First, Staff seeks to disallow Aqua's $10,000 donation to the Danville Area Economic Council. Staff asserts the donation constitutes a social or service club "due" because Aqua makes the donation by renewing its membership and the invoice for membership renewal includes the term "due." (Staff IB, p. 28). However, the manner in which Aqua makes this donation provides no insight into how the Danville Area Economic Council uses the donation. Staff presumes that Aqua receives social benefits from its dues, (*id.*, p. 29), but the evidence establishes unequivocally that Aqua does not. (Aqua Ex. S-2.0, p. 27). Mr. Schreyer testified that the donation is actually used to recruit future business to the Danville area, which benefits the whole community. (Aqua Ex. R-2.0, p. 33). Accordingly, the donation is made for the purpose of benefiting the public welfare and should be recovered.

Second, Staff seeks to disallow eleven contributions because the recipients thank donors by recognizing them in event programs. (Staff IB., p. 29). Without considering whatsoever what purpose the donations were actually used for, Staff summarily disallows the contributions fully. The full disallowance equates to a finding that 100% of the contributions were used for the token thank yous in the event programs, which Aqua did not even request, when in actuality the evidence establishes the donations were used for purposes that fall entirely within Section 9-227. (See Aqua IB, pp. 25-27). At a minimum, a much smaller percentage than 100% of the donation should be deemed to go to the token thank you rather than the actual purpose of the recipient.

Third, Staff disallows the last category simply because individuals receive the donations rather than organizations. (Staff IB, pp. 29-30). This rationale, once again, overlooks substance. The evidence establishes that these donations are made for educations purposes, and in the case of the College Scholarships, also for the purpose of protecting the environment. (*See*, Aqua IB, pp. 27-28). Section 9-227 dictates that these types of donations are recoverable regardless of who the recipient happens to be.

The actual purposes of all Aqua's contributions, therefore, satisfy the statutory standard. Staff's adjustment is erroneous for failing to apply the statutory standard correct. No aspect of the adjustment should be adopted.

6. Rate Case Expense: Aqua Has Fully Supported This Known And Measurable Change

Staff takes issue with Aqua's proposed addition of $102,000 to rate case expense[10] (which would be amortized over three years at $34,000 annually) based upon Staff's erroneous claim that the Company did not timely inform, or provide support for such addition, to Staff. (Staff IB, pp. 39-45). Staff's claim is in conflict with the facts. Moreover, its reliance on a 1994 Commission Order is misplaced. (*Id.*, pp. 43-45).

Staff was first informed that Aqua's rate case expense would increase by an additional $102,000 in August 2004, in response to a Staff Data Request MHE 1.10. In that Data Request Response, Aqua provided information supporting its adjustment to rate case expense. (*See*, Aqua

[10] As discussed in Aqua's Initial Brief, this increase was caused by several factors, including the need to re-litigate issues already ruled upon by the Commission, like incentive compensation, the need to litigate a proposal to remove $19, 246 in Collections Expense from Management Fees that never existed and the need to respond to voluminous data requests on an effective proposed increase of only 3.54%.

Ex. R-2.0, p. 39 (Aqua witness Mr. Schreyer testifying to this fact); *see also*, Tr., pp. 85-86 (information provided in response to MHE 1.10 being discussed on objection)).

Aqua then reflected this amount in its Rebuttal Testimony, filed in October 2004, and further explained the basis for this amount in its Surrebuttal Testimony, filed in November 2004 (Id.; Aqua Ex. S-2.0, p. 30). Aqua subsequently submitted to Staff invoices from its outside counsel reflecting $108,048.37 of actual fees incurred for legal services through the end of October 2004. (Aqua Ex. H-2.0). This was the most up-to-date information that Aqua could provide to Staff prior to hearing. Then, at hearing, Aqua witness Schreyer testified to this information and also noted that Aqua would incur costs related to the November 2004 hearings and subsequent briefings on the issues. (Tr. pp. 81, 94-95).

The invoices at issue are not novel. While they may be in a format to which Staff witness Everson is unaccustomed,[11] they reflect costs incurred as a result of prosecuting the rate case. (Tr., p. 80). While Staff complains that such invoices were received late, their Brief is silent on the fact that Ms. Everson either was unavailable to look at such material, or chose not to look at such material, in the days leading up to evidentiary hearings. (Tr., p. 216). Aqua should not be punished for providing the most up-to-date information to Staff prior to hearings, when it had informed Staff months earlier of the modification of position and the basis for such modification.

In this regard, Staff's reliance on the Commission's Order in *Consumers Illinois Water Company*, ICC Docket Nos. 93-0253, 93-0303, entered May 11, 1994, is entirely misplaced. (Staff IB, pp. 43-45). In that matter, the Company submitted documentation to support a change to a rate base item, a sewage treatment plant, a few days before hearings. Indeed, as Staff notes, the concern was about contract terms, reasonableness of construction schedule, and ratemaking

[11] Importantly, Ms. Everson did not testify that these costs should be disallowed simply because the invoices may look different than others she has reviewed. (Tr., pp. 220-21).

implications. (*Id*., p. 44). Of course, with a rate base item, issues concerning whether the plant would be used and useful likely would also be part of the analysis as well.

Such complex analyses do not exist in this instance. The consideration of legal fees relating to a rate case do not concern interpretation of contract terms, construction schedules, or used and useful analyses. Moreover, the record is devoid of any analysis that Staff conducted concerning the original proposed Rate Case Expense.

Instead, the question is whether the Company incurred such costs related to the prosecution of this rate case. Here, the record reflects that Staff was informed about such modification and the basis for such modification well in advance of hearings. The information that was provided to Staff prior to hearings merely served to corroborate the Company's earlier modification to rate case expense. Indeed, even outside counsel for Aqua stipulated that such information had been sent from counsel's office to the Company. (Tr., p. 87). No extensive analysis is necessary, not withstanding Staff's purported claims to the contrary. Accordingly, the facts found in the Commission's *Consumers Illinois Water Company* Order are inapposite to the facts before the Commission in this proceeding.

In conclusion, the evidentiary record demonstrates that Aqua has incurred additional legal costs prosecuting this proceeding. Many of these costs have been documented, with remaining costs incurred subsequent to October 2004. Accordingly, the Commission should find that Aqua's proposed amendment to its rate case expense to be reasonable.

C. Rate Of Return

1. Capital Structure, Cost Of Preferred Stock, And Cost Of Debt

As noted in Aqua's Initial Brief, it is accepting, for purposes of this case, Staff's proposed capital structure, cost of preferred stock and cost of short-term and long-term debt.

2. Cost Of Common Equity

The Commission is required to permit a level of earnings sufficient to maintain the integrity of presently invested capital and permit the attraction of needed new capital at a reasonable cost in competition with other comparable risk firms. *Bluefield Water Works and Improvement Co. v. West Virginia Public Serv. Comm'n.*, 262 U.S. 679 (1923); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Aqua has fully demonstrated that its requested common equity cost rate of 10.75% is necessary to accomplish this end. In fact, Ms. Ahern has testified that in her expert opinion a much higher rate of 11.35% actually is necessary to do so. She also has testified to the fact that Staff's proposed common equity cost rate of 10.07%, a significant 128 basis points ("bps") less than Ms. Ahern deems appropriate, is seriously inadequate. She has identified numerous flaws in Staff's analysis that cause the inadequate result.

a. Aqua's Requested Rate Of 10.75% Should Be Adopted

Staff spends extensive time in its Initial Brief essentially regurgitating substantial testimony on cost of common equity. Staff is not successful, nonetheless, in rebutting the merits of Ms. Ahern's analysis. Ms. Ahern refuted in testimony each and every one of the arguments Staff advances. In particular, Ms. Ahern responded to Staff on pages 15 to 44 of her Rebuttal Testimony. To avoid a total regurgitation of this material, Aqua respectfully refers the Commission to the totality of Ms. Ahern's testimonial responses. (*See*, Aqua Ex. R-3.0, pp. 15-44; *see also*, Aqua Ex. S-3.0, pp. 1-13). The major points are set forth herein.

i. Size-Based Risk Premium

Staff argues incorrectly that there is no "theoretical" basis for a size-based risk premium and that, if one is applied, it should be based on the size of Aqua America, Inc. rather than Aqua Illinois. (Staff IB, pp. 56-58). Ms. Ahern responded that theoretical reasons as well as common sense and empirical reasons for such an adjustment exist. (Aqua Ex. R-3.0, p. 18). She explained that the effect of size on risk is directly observable in the market-place, and that many factors like lack of liquidity and transaction costs increase the riskiness of small firms. (*Id.*) Ms. Ahern refuted Staff's assertion that the risk should be that of Aqua America as follows:

- The risk analysis must be specific to the purpose for which the analysis is performed. (*Id.*, p. 16). Since the purpose of the analysis here is to assess the risk of investing in Aqua's rate base, (*i.e.*, the asset), the relevant risk is that of Aqua Illinois. (*Id.*)
- There is no evidence that Aqua America's ownership has enhanced Aqua Illinois' capital attraction. (*Id.*, p. 17).
- Ratepayers will receive the benefits of cost reductions from efficiencies through the operating expense component of the revenue requirement. (*Id.*)
- Aqua Illinois stands independent in the capital markets, and investors (including Aqua America) will look elsewhere if Aqua Illinois' riskiness is compensated. (*Id.*)

ii. NAIC-2 Designation

See discussion *infra* at pages 29 to 31.

iii. Reliance On Historical Data

Staff argues erroneously that Ms. Ahern improperly weighs historic data that reflect conditions that may not continue in the future. (Staff IB, pp. 62-64). However, Ms. Ahern explained that rate of return analysis is intended to emulate investor behavior, and investors utilize historic information in deriving their required returns. (Aqua Ex. R-3.0, p. 23). Ms. Ahern testified further that Staff is speculating as to whether historic condition will continue in the future. (*Id.*) She explained that the water industry is not experiencing dramatic changes like other utility industries, (*i.e.*, deregulation and restructuring), and that while past events will not repeat exactly, the event-types of a period can be expected to recur. (*Id.*)

iv. DCF Analysis

Staff asserts that Ms. Ahern's DCF analysis is improper for relying on growth rates for which not all data is available, using a "BR+SV" circular growth estimate and for removing the low estimates. (Staff IB, pp. 64-66). Ms. Ahern responded that reasonable assumptions were developed for Value Line forecasted growth in dividends and earnings per share such that her analysis is populated with complete fields in these areas. (Aqua Ex. R-3.0, p. 26). As for the circularity of "BR+SV," Ms. Ahern testified:

> The circularity of using "BR+SV" is identical to the circularity inherent in using analysts' earnings growth forecasts. Implicit in estimated future earnings is an expected return on common equity. Furthermore, the use of the DCF in rate regulation is itself inherently circular as both the growth rate proxy and market prices are dependent, in part, upon investors' expectations of future earnings that are determined by many regulatory commissions by applying a DCF indicated common equity cost rate to the common equity financed portion of a utility's rate base. Moreover, the circularity of Ms. Phipps' own determination of common equity cost rate is further exacerbated by her use of a DCF-based market return in her risk premium, *i.e.*, CAPM, analysis as previously discussed.

(*Id.*, p. 27). Finally, Staff's objection to Ms. Ahern's removal of the low estimates is one-sided because Ms. Ahern also removed the high estimates and Staff' certainly does not argue that the high estimates should be re-included in the analysis.

v. CAPM Analysis

Staff argues that Ms. Ahern's first Ibbotson-based estimate should not have used historical data,[12] and that Ms. Ahern, for her second estimate, improperly used the median dividend yield and growth rates from two different samples. (Staff IB, pp. 67-68). Ms. Ahern responded that her use of the arithmetic mean of the long-term historical equity total earned return rates is entirely appropriate because the arithmetic mean return is the best estimate of the

[12] S*ee also supra*, p. 24 (responding to Staff's objection to the use of historical data generally).

next expected value for the total return on common stocks. (Aqua Ex. R-3.0, p. 28). She further explained that absent the valuable insight of the prospect for variance (*i.e.*, risk), provided by the arithmetic mean, investors cannot meaningfully evaluate prospective risk. (*Id.*) As to the use of the medians, Ms. Ahern testified that the median is actually the better estimate of the central tendency of the individual securities because it is not influenced by extremely high or low observations. (*Id.*, p. 30). She finally explained that the merit of her CAPM analysis is demonstrated by the fact that the average Value Line dividend yield of dividend paying stocks she utilized of 1.62% is nearly identical to the 1.60% dividend yield of the S&P 500 at the end of the first quarter 2004. (*Id.*, pp. 30-31).

vi. Empirical CAPM

Staff objects that Ms. Ahern used in her Empirical CAPM analysis Value Line adjusted betas rather than raw (*i.e.*, unadjusted) betas, which Staff asserts should be used given a study by *Litzenberger, et al.* (Staff IB, pp. 68-70). Ms. Ahern explained, however, that Staff's references to *Litzenberger, et al.* are not correct. (Aqua Ex. R-3.0, p. 32). Rather, Litzenberger, *et al.* used both adjusted and unadjusted betas in their study. (*Id. citing* Aqua Sch. R-3.1 (a copy of the article by Litzenberger, *et al.*)). Ms. Ahern testified further:

> [T]heir conclusion was that for utilities with a beta less than one and with lower than average residual, *i.e.*, non-diversifiable, risk, cost of capital estimates using Bayesian or statistically adjusted betas and a linear relationship, *i.e.*, traditional CAPM, between risk premia and betas "would be lower than that obtained using a linear relationship estimated with unadjusted or globally adjusted betas." (Note that Value Line betas are globally adjusted betas.) In addition, they conclude by stating that these results "indicate the importance of further research on the revision of betas towards unity. They *do not* state that globally adjusted betas, such as Value Line's, "are a solution to the discrepancy between the theoretically predicted and empirically observed relationship between risk and return"

(*Id.* (internal citations and footnotes removed)(emphasis in original)).

vii. Risk Premium Analysis

Staff argues that Ms. Ahern improperly (a) applied a market risk premium-based beta to a non-market risk premium, (b) substituted two different long-term bond yields for the risk-free rate; and (c) estimated the common equity risk premium by using historical, S&P Public Utility Index data that is not comparable. (Staff IB, pp. 70-72). As to Staff's first alleged criticism, Ms. Ahern testified that Staff is simply not correct. (Aqua Ex. R-3.0, pp. 37-38). Ms. Ahern also explained that Staff's second argument would introduce an inconsistency into the model because "[i]t is a mismatch and a violation of risk premium theory to add a market equity risk premium which reflects total market risk to a public utility bond yield in a risk premium analysis that reflects the risk of public utilities." (*Id.*, p. 38). She further explained that Staff's assertions directly conflict with the basic financial concept of risk return, namely that the risk of the utility industry is lower than the risk of the market as a whole, *i.e.*, general corporate America. (*Id.*, p. 39). Finally, responding to Staff's third argument, Ms. Ahern explained that her common equity risk premium was appropriately derived based on all the available data,[13] and that she did not simply use the S&P Public Utility Index data but rather adjusted it to be applicable to the company's in her proxy groups. (*Id.*, pp. 39-40).

viii. CEM Analysis

Staff argues that Ms. Aherns CEM analysis should not utilize historical data,[14] is affected by different accounting practices across industries, is not market-based and relies on book-returns. (Staff IB, pp. 72-75). Ms. Ahern explained that disparate accounting practices are irrelevant because the criteria she used to select the non-utility companies in her analysis were based upon total risk, (*i.e.*, the sum of non-diversifiable, market risk and diversifiable, non-market or company-specific risk), which obviates all impacts of accounting differences. (Aqua

[13] S*ee supra*, p. 24 (responding to Staff's objection to the use of historical data).
[14] S*ee supra*, p. 24 (responding to Staff's objection to the use of historical data).

Ex. R-3.0, p. 40). Ms. Ahern also explained that her analysis is market-based because the selection of non-price regulated firms of comparable risk is based upon statistics derived from the market prices paid by investors. (*Id.*, pp. 40-41). Finally, she testified that because the rates set in this proceeding will be applied to Aqua's original, depreciated cost or book rate base, a combination of realized and expected returns on book value is an appropriate estimate for investor required returns on book value. (*Id.*, pp. 41-42).

In summary, none of Staff's arguments against Ms. Ahern's analysis withstand scrutiny. The evidence demonstrates, therefore, that Ms. Ahern's analysis producing a common equity cost rate of 11.35% is appropriate and fully supports Aqua's requested rate of 10.75% as necessary to provide Aqua with an adequate return on its investment. A rate of 10.75% should be adopted.

b. Staff's Analysis Should Not Be Adopted But, If For Some Reason It Is, The Major Flaws Must Be Corrected

Not only has Staff been unsuccessful in identifying any errors in Ms. Ahern's analysis, but Staff has also been unsuccessful in dispelling the errors Ms. Ahern has identified in Staff's own analysis. Again, to avoid a total regurgitation of this material, Aqua respectfully refers the Commission to the totality of Ms. Ahern's testimony setting forth these errors. (*See*, Aqua Ex. R-3.0, pp. 7-15; *see also*, Aqua Ex. S-3.0, pp. 1-13). The flaws in Staff's analysis were also discussed in Aqua's Initial Brief. (*See*, Aqua IB, pp. 30-36). The cumulative result of the errors Ms. Ahern has identified is a serious downward bias that causes Staff's proposed rate of 10.07% to be inadequate. Accordingly, the Commission should not adopt it.

Nonetheless, if the Commission for some reason does adopt Staff's analysis as the underlying basis for the Commission's approved rate, the Commission should, at a minimum, correct for the most serious flaws:

i. Aqua's NAIC-2 Rating

Staff's analysis rests on an incorrect assumption that distorts its entire analysis. Staff assumes, in particular, that Aqua has the equivalent of an A credit rating. (*See e.g.*, Staff IB, pp. 51, 53-54). The Commission has already held that Staff's assumption is erroneous. In an Order involving Aqua's Kankakee Division, issued in April of this very same year, the Commission stated the following in its discussion of Staff's analysis:

> In this context, it is appropriate to consider all available information of record, including the rating of NAIC-2 on certain of [Aqua Illinois'] securities issues. When compared to the credit rating of A discussed earlier [*i.e.*, the same rating Staff erroneously assumes to exist in this case], the rating of NAIC-2, or a comparable S&P rating of BBB, indicates the presences of some additional risk factor not already explained.

(Order, Dkt. No. 03-0403, p. 43). The Commission added 30 bps to account for Aqua's additional risk not reflected in the A credit rating assumed in Staff's analysis. (*Id.*)

Like Docket No. 03-0403, the evidence in this case establishes that Aqua's debt issuances have been assigned an NAIC-2 rating. (Aqua Ex. 3.0, p. 14). Aqua has provided Staff copies of reports assigning the NAIC-2 rating to Aqua's recent debt issuances. (Aqua response to Staff Data Request FD-33). Staff's failure to adjust its analysis to account for the additional risk Aqua's NAIC-2 rating represents is a serious flaw that must be corrected should the Commission for some reason adopt Staff's analysis as the basis for its approved cost of common equity rate.

In its Initial Brief, Staff urges the Commission to rule on this issue inconsistently than it did in Docket No. 03-0403. As discussed *supra*, while Commission rulings are not *res judicata*, the Commission must have a rationale basis for acting inconsistently in different proceedings or its actions will be deemed arbitrary and capricious. (*See supra*, pp. 9-10). Staff has provided no reasonable basis for the Commission to depart from the ROE analysis it used for Aqua's

Kankakee Division just eight months ago. Consequently, Staff's attempt to re-litigate this issue should be rejected.

Staff primarily urges the Commission to rule differently by advancing Staff's opinion that an NAIC-2 designation should not be relied upon in assessing risk. Staff argues this is so because (a) NAIC rates security issues rather than companies, (b) NAIC issues its ratings for its insurance commission membership, (c) Moody's and S&P do not provide their own translations of equivalent ratings to NAIC designations; and (d) NAIC does not measure general investment risk. (Staff IB, pp. 58-60). These arguments are non-starters because, as noted, the Commission has already deemed Aqua's NAIC-2 rating a reliable basis to assess risk.[15] (Order, Dkt. 03-0403, p. 43).

Staff also argues secondarily that the Commission can disregard the evidence of Aqua's NAIC-2 designation simply because Staff performed what it calls a quantitative risk analysis.[16] (Staff IB, p. 60). However, Staff itself describes the analysis it performed as "questionable." (Staff Ex. 7.0, p. 8). Moreover, Ms. Ahern explained that Staff's "questionable" quantitative risk analysis did nothing to rectify Staff's failure to account for Aqua's NAIC-2 rating. (Aqua Ex. S-3.0, p. 4 (explaining that Staff's analysis continued to understate Aqua's risk for *all* the reasons Ms. Ahern had identified in her Rebuttal Testimony)). In other words, Aqua's NAIC-2 rating is relevant, available information that should not be disregarded simply because Staff performed a minor amount of additional analysis. A fundamental principle of investment theory is that investors utilize *all* available information. (*See e.g.*, Aqua Ex. 3.0, p. 19 (explaining that the

---

[15] Staff argues that the Commission did not specifically reject these arguments in Docket No. 03-0403. (Staff IB, p. 61). However, the Commission clearly did reject Staff's arguments even though it may not have explicitly stated the fact that it was doing so. This is clear because the Commission did, in fact, rely on Aqua's NAIC-2 rating despite Staff's arguments that Aqua's NAIC-2 rating should not be considered or relied upon.

[16] Ms. Ahern selected the companies in her proxy group only after considering several operating and financial ratios, and explained that Staff's analysis was flawed because Staff did not do so. (Aqua Ex. 3.0, p. 10). In response, Staff did consider these factors with respect to the companies Staff had already selected. (Staff Ex. 7.0, pp. 7-8).

Efficient Market Hypothesis, which is the foundation of investment theory, holds as a primary rule the use of all available information)). Following this well-established principle, the Commission stated in Docket No. 03-0403, as noted *supra*, that "[i]n this context [of common equity cost analysis], it is appropriate to consider all available information of record, including the rating of NAIC-2 on certain of [Aqua Illinois'] securities issues." (Order, Dkt. 03-0403, p. 43). Aqua's NAIC-2 rating is once again relevant, reliable and available information for which the analysis the Commission adopts to support its approved common equity cost rate should account.

ii. Increased Interest Rates

Staff's analysis also fails to account for the increased interest rate environment since the Commission's Order in Docket No. 03-0403. At the time the Commission issued its Order in that Docket, Moody's A rated public utility bond yields averaged 5.97% and Baa rated public utility bond yields averaged 6.12%. (Aqua Ex. R-3.0, p. 5). In comparison, for the month of August, 2004, "Moody's A and Baa rate public utility bond yields averaged 6.14% and 6.45% respectively, an increase of 0.17% (17 bps) and 0.33% (33 bps)" respectively.[17] (*Id.*) And interest rates are projected to continue rising. (*Id.*)

It is fundamental that common equity cost rates increase when interest rates increase. Yet, Staff's proposed rate of 10.07% in today's higher interest rate environment is below the 10.16% the Commission adopted in Docket No. 03-0403, which equates to 10.49% in today's higher interest rate environment. (*Id.*, pp. 5-6). Staff does not advance a single argument against

[17] Ms. Ahern testified that Moody's Baa rate public utility bond yields is the proper basis for the adjustment due to Aqua's NAIC-2 rating. (Aqua Ex. R-3.0, pp. 5-6).

this adjustment in its Initial Brief.[18] The Commission should adjust Staff's proposed rate to reflect today's higher interest rates should the Commission for some reason rely on Staff's analysis as the basis for its approved common equity cost rate.

D. Rate Design

Staff proposes three changes to Aqua's suggested rate design. These changes relate to the Fourth Usage Block, the Customer Charge, and the Large Industrial Customer Class. As noted in Aqua's Initial Brief, (Aqua IB., p. 36), provided the Commission accepts the relation between the first three usage block rates that Staff proposes, (Staff Ex. 8.1, p. 1), Aqua will accept Staff's proposed adjustment. It is Aqua's position, though, that the remaining proposed Staff adjustments are inappropriate and should not be accepted.

1. Customer Charge

Staff proposes to maintain the existing rate for Aqua's customer charge, except for one customer – Teepak, based entirely on cost of service ("COS") principles. (Staff IB, pp. 84-87). In particular, Staff argues that the role customer charges have historically played in Aqua's overall rate design effectively should be lessened or brought closer to actual COS by maintaining the rates, with the Teepak exception, at current levels without even recognizing the 5% QIPS. (*Id.*, pp. 85-86). Again, the sole factor considered in Staff's position is COS.

As Aqua witness Mr. Monie has explained, however, rate design should consider all relevant factors, not just COS. (*See*, Aqua IB, p. 39). Indeed, the Commission historically has adopted rates for Aqua that are designed to accomplish goals unrelated to COS. One of the

[18] Indeed, Staff only advanced a minor argument in testimony, and the argument did not even pertain to the merits of Aqua's proposal, (*i.e.*, Staff did not argue that it is not appropriate to adjust for changes in interest rates). Rather, Staff's comment went only to the time period for comparison of interest rates, in that Staff necessarily performed its analysis in Docket No. 04-0304 earlier than when the Commission issued its Order in April, 2004. (Staff Ex. 7.0, p. 13). As Ms. Ahern explained, however, the Commission's Order in Docket No. 04-0304 constitutes a finding that 10.16% was an appropriate rate at the time the Commission issued its Order in April, 2004. (Aqua Ex. S-3.0, p. 4). The appropriate time period for comparison, therefore, is April, 2004.

goals, as discussed *infra*, has been to keep Teepak as a customer on Aqua's system. As such, rates historically have deviated from COS.

Mr. Monie testified that Staff's position to move rates toward COS now would be a radical shift in Aqua's overall rate design. (Aqua Ex. S-4.0, pp. 3-4; *see also*, Aqua IB, p. 37 (discussing this evidence)). He further explained that the 5% Qualifying Infrastructure Plant Surcharge ("QIPS"), while it may be set forth on customer bills in a separate line item, is in all meaningful senses a part of the current customer charges. (Tr., pp. 182-83). Staff's position against officially recognizing in customer charges the pre-existing 5% QIPS, which is already, in effect, part of customer charges, would amount to the elimination of an aspect of customer charges already being assessed. In fact, Mr. Monie testified that if the Commission, for some reason, does not adjust for the pre-existing QIPS, the result will be a rate decrease for some customers. (Aqua Ex. S-4.0, p. 3).

2. Large Industrial Customer Class Rate - Teepak

Aqua serves one customer under its Large Industrial Customer Class rate – Teepak. (Aqua Ex. R-4.0, p. 5). In its' rate design proposal, Aqua seeks to increase Teepak's rates by 1%, exclusive of the 5% QIPS-related increase. In stark contrast, Staff proposes to increase Teepak's rates by 35%, exclusive of the QIPS-related increase. (Staff IB, pp. 87-90). Staff's proposal fails to appropriately consider the impact of such an enormous rate increase on the region's largest employer. Indeed, Staff's proposal seeks to have the Commission take the risk that such an increase will not force Teepak off the Aqua system, or possibly move its manufacturing operations out of the State. Aqua submits that Staff's proposal is not sound regulatory policy.

Staff's proposal is premised primarily on the application of cost of service principles. (Tr., p. 280). Staff claims that its proposal is reasonable because it allows Teepak a substantial discount from its actual cost of service, (Staff IB, p. 88), and states that its proposed rate is "steeply discounted." (*Id*., p. 90). Aqua respectfully submits that Staff's position emphasizes theory at the expense of reality. A 35% increase over present rates is nothing less than rate shock.

The evidence demonstrates that Teepak may leave the Aqua system, and even move its operations from the State in the event Staff's proposal is accepted. (Aqua Ex. R-5.0, p. 6). Moreover, the Mayor of Danville and other civic organizations have urged that the Commission to consider the social and economic impacts related to Teepak's continuing operations in the area. (*Id*., pp. 6-7, Att. R4-2). Indeed, they urge the Commission to adopt Aqua's rate proposal. (*Id*.)

Staff discounts the possibility of Teepak leaving the Aqua system. (Staff IB, pp. 89-90). Such discounting, however, is based on supposition, not independent factual investigation. Here, Staff witness Luth never attempted to discuss the matters with Teepak management, the Mayor of Danville, or local civic organizations. (Tr., pp. 285-88). Staff also criticizes the analysis Teepak conducted when developing its preliminary assessment about whether to bypass the Aqua system should Staff's rate proposal be accepted. (Staff IB, pp. 89-90). However, Staff witness Luth is not an engineer, never designed a well/water treatment facility, and never operated such a facility. (Tr., pp. 282-83). In this regard, Staff's criticisms are based on speculation, not independent, analytical investigation.[19]

[19] Indeed, Staff alleges for the first time in its Initial Brief that either Teepak's cost estimate is incorrect or Aqua has not controlled its costs if Teepak can leave the system cost effectively. (Staff IB, pp. 89-90). There is no evidence in the record to support this disingenuous allegation from Staff. Moreover, there is no issue whether Aqua can provide water service to TeePak cheaper than TeePak can provide it to itself. Of course Aqua can and has provided water service to TeePak cheaper than Teepak can provide to itself for many years. Both the current tariff design and the Company proposed tariff design not only charges this lower rate, but allows for a contribution to the capital for serving the rest of the Company's system. The only issue here is how much of a contribution to the capital of Aqua system should TeePak make.

Additionally, Staff's position fails to consider the Commission's Order just four years ago where it approved a minimal 2.5% increase for Teepak based on the evidence that Teepak would leave the Aqua system by building its own alternative water supply. (Order, Dkt. 00-0339, p. 9). Staff concurred with this assessment in that proceeding as well. (Staff Ex. 5.0, Pilapil Testimony, pp. 18-19, Dkt. No. 00-0339).

Finally, Staff's position is based on its purported review of Teepak's financial condition. Staff's assessment, though, is inappropriately based on Teepak Holdings website, (Staff Ex. 4.0, p. 14), which does not provide the relevant information. The relevant company information is that from the Teepak Americas Region, which was submitted to but not relied upon by Staff. (*See*, Aqua Cross Ex. 5 (response to ML-24)(setting forth the actual profit/loss from the Teepak Americas Region)). Consequently, Staff's claims on this point are irrelevant to an appropriate analysis.

In sum, Staff seeks to have the Commission take the risk that Teepak will not leave the Aqua system, or move its manufacturing operations from the State, if Staff's proposed 35% rate increase is approved. Aqua is unwilling to take this chance. (Tr., pp. 189-90). Rate design is not a science. (Tr., pp. 292-93). When establishing rates, the Commission should consider costs, as well as social, economic and political concerns. (Aqua Ex. R-4.0, pp. 7-8). Staff's rate design proposal fails to consider such real concerns in an effort to focus on theory. Accordingly, Aqua submits that Staff's proposed rate design for its Large Industrial Class Rate should be rejected.

III.
Conclusion

WHEREFORE, for each and every one of these reasons, Aqua Illinois, Inc. respectfully requests that the Commission enter an order consistent with the arguments set forth herein.

Dated: December 17, 2004

Respectfully submitted,

AQUA ILLINOIS, INC.

By: ______________________________
One of its attorneys

John E. Rooney
Sarah A. Naumer
Sonnenschein Nath & Rosenthal
233 South Wacker Drive
Chicago, Illinois 60606
(312) 876-8000
jrooney@sonnenschein.com
snaumer@sonnenschein.com

CERTIFICATE OF SERVICE

I, John E. Rooney, an attorney, hereby certify that I caused to be served a copy of the Reply Brief of Aqua Illinois, Inc. upon the service list in Docket No. 04-0442 by email on December 17, 2004.

John E. Rooney